

# **Legislative Audit Division**

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**State of Montana**



**Report to the Legislature**

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**November 2006**

## **Financial-Compliance Audit For the Two Fiscal Years Ended June 30, 2006**

### **Montana State Fund**

**This is our financial-compliance audit report on the Montana State Fund for the two fiscal years ending June 30, 2006. The objectives of our financial-compliance audit include determining if the Montana State Fund's financial statements present fairly its financial position and results of operations at and for the period ending June 30, 2006, with comparative totals at and for the period ending June 30, 2005.**

**We tested the Montana State Fund's compliance with state laws that have a direct and material impact on the financial statements. We also completed additional compliance testing with applicable laws and regulations as part of this financial-compliance audit.**

**This report contains no recommendations.**

**Direct comments/inquiries to:  
Legislative Audit Division  
Room 160, State Capitol  
PO Box 201705  
Helena MT 59620-1705**

**06-05**

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## FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2007, will be issued by March 31, 2008. The Single Audit Report for the two fiscal years ended June 30, 2005, was issued on March 6, 2006. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator  
Office of Budget and Program Planning  
State Capitol  
Helena MT 59620  
Phone (406) 444-3616

Legislative Audit Division  
Room 160, State Capitol  
PO Box 201705  
Helena MT 59620-1705

### MEMBERS OF THE LEGISLATIVE AUDIT COMMITTEE

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# LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
Tori Hunthausen,  
Chief Deputy Legislative Auditor



Deputy Legislative Auditors:  
James Gillett  
Jim Pellegrini

November 2006

The Legislative Audit Committee  
of the Montana State Legislature:

This is our report on the financial-compliance audit of the Montana State Fund, a component unit of the state of Montana, for the two fiscal years ended June 30, 2006. The objectives of this audit include determining if the financial statements for fiscal year 2005-06, with comparative financial amounts for fiscal year 2004-05, present fairly the Montana State Fund's financial position at June 30 for each fiscal year and the results of its operations for the fiscal years then ended. We also tested compliance with laws related to operations of the Montana State Fund.

Montana State Fund is a workers' compensation insurance company established by the state of Montana. It is a nonprofit, quasi-public entity that provides Montana employers with an option for workers' compensation and occupational disease insurance. Montana State Fund is governed by a seven-member board of directors appointed by the governor. State law separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund).

Montana State Fund management must set premium rates at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain an excess of surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings. The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies established in law.

We made no recommendations to Montana State Fund in the current or prior audit report. On page A-1, you will find the Independent Auditor's Report followed by the Management Discussion and Analysis, the financial statements and accompanying notes. The Management Discussion and Analysis is supplementary information required by the Governmental Accounting Standards Board. As disclosed in the Independent Auditor's Report, we did not audit the information and express no opinion on it. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page B-1. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

*/s/ Scott A. Seacat*

Scott A. Seacat  
Legislative Auditor

## **Appointed and Administrative Officials**

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### **Montana State Fund**

Laurence Hubbard	President/CEO
Mark Barry	Vice President, Corporate Support
Tony Johnson	Vice President, Human Resources
Layne Kertamus	Vice President, Insurance Operations
Peter Strauss	Vice President, Insurance Operations Support
Nancy Butler	General Counsel
Al Parisian	Chief Information Officer

### **State Fund Board of Directors**

	<u>Term Expires</u>
Ed Henrich	2007
Mardi Madsen	2007
Jane DeBruycker	2009
Ken Johnson	2009
Jim Swanson	2009
Lance Zanto	2009

For additional information concerning the Montana State Fund, contact:

Laurence Hubbard, President/CEO  
5 South Last Chance Gulch  
Helena MT 59601  
(406) 444-6501

Members of the audit staff involved in this audit were Chris G. Darragh, Rick Eneas, Laura Norris, Alexa O'Dell, and Vickie Rauser.

# LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
Tori Hunthausen,  
Chief Deputy Legislative Auditor



Deputy Legislative Auditors:  
James Gillett  
Jim Pellegrini

## INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets, New Fund and Old Fund, of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2006, and 2005, and the related Statements of Revenues, Expenses, and Changes in Fund Net Assets, New Fund and Old Fund, and the Statements of Cash Flows, New Fund and Old Fund, for the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2006, and 2005, and the results of its operations and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

*/s/ James Gillett*

James Gillett, CPA  
Deputy Legislative Auditor

October 12, 2006



**Montana State Fund's  
Management Discussion and Analysis,  
Financial Statements and Notes**

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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Management Discussion and Analysis  
June 30, 2006 and 2005

**Description of Business**

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. No State general fund money is used for MSF operations. If MSF is dissolved by an act of law, the money held by MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds held in the Old Fund.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

**Overview of the Financial Statements**

This overview is an introduction to MSF's financial statements. MSF's financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The statement of net assets presents information regarding all of MSF's assets and liabilities, with the difference between the two being reported as net assets.

The statements of revenue, expenses, and changes in fund net assets present the financial results of operations for MSF for the two most recent fiscal years. This statement presents information



showing how the net assets changed during the two most recent fiscal years. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The statement of cash flows details the cash used and provided by the various activities of MSF during the fiscal year. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the fiscal year.

The following analysis presents two years of comparative condensed financial data.

### **Analysis of Financial Position**

The following is a comparison of the financial position of MSF at June 30, 2006 to 2005, (In thousands):

	<u>6/30/2006</u>	<u>6/30/2005</u>	<u>Change</u>
Assets:			
Cash and Short-Term			
Investments	\$14,919	\$32,157	(\$17,238)
Investments	738,858	656,029	82,829
Security Lending Collateral	132,439	101,859	30,580
Receivables (Net)	16,494	13,670	2,824
Capital Assets (Net)	6,601	4,690	1,911
Other Assets	17,313	8,429	8,884
Total Assets	<u>926,624</u>	<u>816,834</u>	<u>109,790</u>
Liabilities:			
Loss Reserves and Loss			
Adjustment Expense Reserves	590,688	511,557	79,131
Liability for Securities on Loan	132,439	101,859	30,580
Payables	19,727	14,973	4,754
Other Liabilities	<u>26,185</u>	<u>19,770</u>	<u>6,415</u>
Total Liabilities	<u>769,039</u>	<u>648,159</u>	<u>120,880</u>
Net Assets:			
Investment in Capital Assets	6,601	4,690	1,911
Unrestricted Net Assets	<u>150,984</u>	<u>163,985</u>	<u>(13,001)</u>
Total Liabilities and Net Assets	<u>\$926,624</u>	<u>\$816,834</u>	<u>\$109,790</u>

Net Assets decreased approximately (\$11.1M) (million) from the prior year. The decrease has primarily resulted from an unrealized loss on investment in fixed securities of (\$27.3M).

The change in book value of MSF's investment portfolio of fixed and equity securities in fiscal year 2006 was as follows, (In thousands):

<b>Fiscal Year 2005 Book Value</b>	<b>\$635,045</b>
Purchases at Cost	190,362
Sales	(86,850)
Net Realized Losses	(256)
Net Accretion of Bonds	213
<b>Fiscal Year 2006 Book Value</b>	<b><u>\$738,514</u></b>

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2006 and June 30, 2005. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2006 and 2005. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at \$590.7M and \$511.6M, as of June 30, 2006, and June 30, 2005, respectively.

The following is a comparison of the financial position of MSF at June 30, 2005, to June 30, 2004, (In thousands):

	<u><b>6/30/2005</b></u>	<u><b>6/30/2004</b></u>	<u><b>Change</b></u>
<b>Assets:</b>			
Cash and Short-Term			
Investments	\$32,157	\$20,685	\$11,472
Investments	656,029	582,068	73,961
Security Lending Collateral	101,859	141,060	(39,201)
Receivables (Net)	13,670	13,393	277
Capital Assets (Net)	4,690	2,349	2,341
Other Assets	8,429	2,038	6,391
<b>Total Assets</b>	<u><b>816,834</b></u>	<u><b>761,593</b></u>	<u><b>55,241</b></u>
<b>Liabilities:</b>			
Loss Reserves and Loss			
Adjustment Expense Reserves	511,557	452,115	59,442
Liability for Securities on Loan	101,859	141,060	(39,201)
Payables	14,973	9,443	5,530
Other Liabilities	19,770	16,203	3,567
<b>Total Liabilities</b>	<u><b>648,159</b></u>	<u><b>618,821</b></u>	<u><b>29,338</b></u>
<b>Net Assets:</b>			
Investment in Capital Assets	4,690	2,349	2,341
Unrestricted Net Assets	163,985	140,423	23,562
<b>Total Liabilities and Net Assets</b>	<u><b>\$816,834</b></u>	<u><b>\$761,593</b></u>	<u><b>\$55,241</b></u>

Net Assets increased approximately \$25.9M from the prior year. The increase has primarily resulted from a decrease in MSF's operating loss and in increase in investment income.

The change in book value of MSF's investment portfolio of fixed and equity securities in fiscal year 2005 was as follows, (In thousands):

Fiscal Year 2004 Book Value	\$567,918
Purchases at Cost	159,381
Sales	(92,981)
Net Realized Gains	1,042
Net Amortization of Bonds	(315)
Fiscal Year 2005 Book Value	<u>\$635,045</u>

Tillinghast-Towers Perrin prepares the actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2005, and June 30, 2004. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2005 and 2004. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at \$511.6M and \$452.1M, as of June 30, 2005, and June 30, 2004, respectively.

### **Results of Operations – MSF**

The following is a comparison of MSF's results of operations for fiscal year 2006 to fiscal year 2005, (In thousands):

	<u>6/30/2006</u>	<u>6/30/2005</u>	<u>Change</u>
Operating Revenues:			
Net Premium Earned	\$211,892	\$189,379	\$22,513
Total Operating Revenue	<u>\$211,892</u>	<u>\$189,379</u>	<u>\$22,513</u>
Operating Expenses:			
Benefits and Claims	192,699	159,612	33,087
Personal Services	18,974	17,168	1,806
Other Operating Expense	17,942	18,757	(815)
Total Operating Expense	<u>229,615</u>	<u>195,537</u>	<u>34,078</u>
Net Operating Income (Loss)	(17,723)	(6,158)	(11,565)
Nonoperating Revenue (Expense):			
Investment Income	32,141	30,128	2,013
Unrealized Gain/(Loss)	(20,640)	6,834	(27,474)
Other Nonoperating Revenue	133	102	31
Dividend Expense	(5,001)	(5,004)	3
Total Nonoperating Revenue (Expense)	<u>6,633</u>	<u>32,060</u>	<u>(25,427)</u>
Change in Net Assets	<u>(\$11,090)</u>	<u>\$25,902</u>	<u>(\$36,992)</u>

MSF's book of business grew from \$189.4M of net earned premium in fiscal year 2005 to \$211.9M of earned premium in fiscal year 2006. Net earned premium increased by \$22.5M

compared to the prior year primarily due to economic growth in the state resulting in an increase in overall payroll levels, the basis for premiums.

MSF paid dividends of \$5.0M to policyholders in fiscal year 2006, this is the same amount of dividends paid to policyholders in fiscal year 2005. The Board of Directors, at its discretion, determines the amount of dividends to be declared, based on MSF's financial condition.

Investment income in fiscal year 2006 increased by \$2.0M over investment income earned in fiscal 2005. This increase was primarily due to an increase in investment in fixed securities of \$82.8M. In fiscal year 2006 MSF had a realized loss on the sales and maturities of investments of (\$0.3M) compared to a realized gain of \$1.0M on sales and maturities of investments in fiscal year 2005.

MSF experienced an unrealized loss on investments of (\$20.6M) in fiscal year 2006. This compared to an unrealized gain on investments of \$6.8M in fiscal year 2005. This decrease was due primarily to the decline in fair value of bonds of (\$27.3M) in fiscal year 2006.

The following is a comparison of MSF's results of operations for fiscal year 2005 to fiscal year 2004, (In thousands):

	<u>6/30/2005</u>	<u>6/30/2004</u>	<u>Change</u>
Operating Revenues:			
Net Premium Earned	<u>\$189,379</u>	<u>\$139,361</u>	<u>\$50,018</u>
Total Operating Revenue	<u>\$189,379</u>	<u>\$139,361</u>	<u>\$50,018</u>
Operating Expenses:			
Benefits and Claims	159,612	139,232	20,380
Personal Services	17,168	15,379	1,789
Other Operating Expense	<u>18,757</u>	<u>19,456</u>	<u>(699)</u>
Total Operating Expense	<u>195,537</u>	<u>174,067</u>	<u>21,470</u>
Net Operating Income (Loss)	(6,158)	(34,706)	28,548
Nonoperating Revenue (Expense)			
Investment Income	30,128	27,733	2,395
Unrealized Gain/(Loss)	6,834	(11,635)	18,469
Other Nonoperating Revenue	102	196	(94)
Dividend Expense	<u>(5,004)</u>	<u>(1,910)</u>	<u>(3,094)</u>
Total Nonoperating Revenue (Expense)	<u>32,060</u>	<u>14,384</u>	<u>17,676</u>
Change in Net Assets	<u>\$25,902</u>	<u>(\$20,322)</u>	<u>\$46,224</u>

MSF's book of business grew from \$139.4M in fiscal year 2004 to \$189.4M in fiscal year 2005. The increase of \$50.0M was driven by a significant number of new policies and increased pricing on renewing policies.

MSF paid dividends of \$5.0M to policyholders in fiscal year 2005, this is an increase of \$3.1M over the dividends paid to policyholders of \$1.9M in fiscal year 2004. The Board of Directors, at its discretion, determines the amount of dividends to be declared, based on MSF's financial condition.

Investment income increased in fiscal year 2005 by \$2.4M. The increase can be attributed to an increased investment in fixed securities of \$69.4M. In fiscal year 2005 MSF had a realized gain on the sale and maturity of investments of \$1.0M compared to a realized gain on the sale and maturity of investments of \$1.1M in fiscal year 2004.

In fiscal year 2005 MSF had an unrealized gain on invested assets of \$6.8M compared to an unrealized loss of (\$11.6M) in fiscal year 2004. The difference was due to unrealized losses on fixed security investments of (\$24.4M) in fiscal year 2004.

### **Analysis of Financial Position – Old Fund**

The following is a comparison of the financial position of the Old Fund at June 30, 2006, to June 30, 2005, (In thousands):

	<u>6/30/2006</u>	<u>6/30/2005</u>	<u>Change</u>
<b>Assets:</b>			
Cash and Short-Term			
Investments	\$8,676	\$12,207	(\$3,531)
Investments	43,252	51,354	(8,102)
Security Lending Collateral	14,894	17,769	(2,875)
Receivables (Net)	680	916	(236)
Total Assets	<u>67,502</u>	<u>82,246</u>	<u>(14,744)</u>
<b>Liabilities:</b>			
Loss Reserves and Loss			
Adjustment Expense Reserves	73,737	79,109	(5,372)
Liability for Securities on Loan	14,894	17,769	(2,875)
Payables	773	949	(176)
Total Liabilities	<u>89,404</u>	<u>97,827</u>	<u>(8,423)</u>
<b>Net Assets:</b>			
Unrestricted Net Assets	<u>(21,902)</u>	<u>(15,581)</u>	<u>(6,321)</u>
Total Liabilities and Net Assets	<u>\$67,502</u>	<u>\$82,246</u>	<u>(\$14,744)</u>

Net Assets decreased (\$6.3M) from the prior year. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining to be paid on outstanding claims. The decreases in net assets have left a deficit in the net asset account of (\$21.9M).

The change in book value of Old Fund's investment portfolio of fixed securities in fiscal year 2006 was as follows, (In thousands):

Fiscal Year 2005 Book Value	\$51,005
Purchases at Cost	13,121
Sales	(20,271)
Net Realized Gains	247
Net Accretion of Bonds	(187)
Fiscal Year 2006 Book Value	<u>\$43,915</u>

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for the Old Fund as of June 30, 2006, and June 30, 2005. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2006 and 2005. The estimated claims payable is presented discounted at \$73.7M and \$79.1M, as of June 30, 2006 and June 30, 2005, respectively. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. The Old Fund discounted its actuarially determined unpaid balances by a factor of 5.0% for the periods ended June 30, 2006 and June 30, 2005. The estimated claims payable undiscounted for fiscal years 2006 and 2005, respectively, is \$97.8M and \$104.9M.

The following is a comparison of the financial position of the Old Fund at June 30, 2005 to June 30, 2004, (In thousands):

	<u>6/30/2005</u>	<u>6/30/2004</u>	<u>Change</u>
<b>Assets:</b>			
Cash and Short-Term			
Investments	\$12,207	\$4,114	\$8,093
Investments	51,354	69,215	(17,861)
Security Lending Collateral	17,769	13,249	4,520
Receivables (Net)	916	1,152	(236)
Total Assets	<u>82,246</u>	<u>87,730</u>	<u>(5,484)</u>
<b>Liabilities:</b>			
Loss Reserves and Loss			
Adjustment Expense Reserves	79,109	80,778	(1,669)
Liability for Securities on Loan	17,769	13,249	4,520
Payables	949	1,146	(197)
Total Liabilities	<u>97,827</u>	<u>95,173</u>	<u>2,654</u>
<b>Net Assets:</b>			
Unrestricted Net Assets	<u>(15,581)</u>	<u>(7,443)</u>	<u>(8,138)</u>
Total Liabilities and Net Assets	<u>82,246</u>	<u>87,730</u>	<u>(5,484)</u>

Net Assets decreased (\$8.1M) from the prior year. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining

to be paid on outstanding claims. The decreases in net assets have left a deficit in the net asset account of (\$15.6M).

The change in book value of Old Fund's investment portfolio of fixed and equity securities in fiscal year 2005 was as follows, (In thousands):

Fiscal Year 2004 Book Value	\$67,653
Purchases at Cost	17,977
Sales	(34,401)
Net Realized Gains	(3)
Net Accretion of Bonds	<u>(221)</u>
Fiscal Year 2005 Book Value	<u>\$51,005</u>

Tillinghast-Towers Perrin prepare the actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for the Old Fund as of June 30, 2005, and June 30, 2004. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2005 and 2004. The estimated claims payable is presented discounted at \$79.1M and \$80.8M, as of June 30, 2005 and June 30, 2004, respectively. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. The Old Fund discounted its actuarially determined unpaid balances by a factor of 5.0% for the period ended June 30, 2005, and 5.25% for the period ended June 30, 2004. The estimated claims payable undiscounted for fiscal years 2006 and 2005, respectively, is \$104.9M and \$108.5M.

### **Results of Operations – Old Fund**

The following is a comparison of Old Fund's results of operations for fiscal year 2006 to fiscal year 2005, (In thousands):

	<u>6/30/2006</u>	<u>6/30/2005</u>	<u>Change</u>
Operating Expenses:			
Benefits and Claims	\$5,521	\$8,671	(\$3,150)
Personal Services	53	13	40
Other Operating Expense	<u>2,609</u>	<u>1,425</u>	<u>1,184</u>
Total Operating Expense	<u>8,183</u>	<u>10,109</u>	<u>(1,926)</u>
Nonoperating Revenue:			
Investment Income	2,871	3,176	(305)
Unrealized Gain/(Loss)	(1,011)	(1,214)	203
Other Nonoperating Revenue	<u>3</u>	<u>9</u>	<u>(6)</u>
Total Nonoperating Revenue	<u>1,863</u>	<u>1,971</u>	<u>(108)</u>
Change in Net Assets	<u>(\$6,320)</u>	<u>(\$8,138)</u>	<u>\$1,818</u>

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF).

The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M for both fiscal years 2006 and 2005. MSF allocated \$1.25M in administration costs to the Old Fund in fiscal years 2006 and 2005. The Old Fund has a \$576K (thousand) obligation to MSF in un-recovered administrative costs incurred in fiscal years 2006 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

The change in net assets for fiscal year 2006 is a reduction of (\$6.3M) compared to a decrease of (\$8.2M) in fiscal year 2005. For an explanation of this decrease in net assets see the section on Analysis of Financial Position – Old Fund.

The following is a comparison of Old Fund's results of operations for fiscal year 2005 to fiscal year 2004, (In thousands):

	<u>6/30/2005</u>	<u>6/30/2004</u>	<u>Change</u>
Operating Expenses:			
Benefits and Claims	\$8,671	\$11,559	(\$2,888)
Personal Services	13	21	(8)
Other Operating Expense	<u>1,425</u>	<u>1,555</u>	<u>(130)</u>
Total Operating Expense	<u>10,109</u>	<u>13,135</u>	<u>(3,026)</u>
Nonoperating Revenue:			
Investment Income	3,176	4,048	(872)
Unrealized Gain/(Loss)	(1,214)	(3,817)	2,603
Other Nonoperating Revenue	<u>9</u>	<u>(733)</u>	<u>742</u>
Total Nonoperating Revenue	<u>1,971</u>	<u>(502)</u>	<u>2,473</u>
Change in Net Assets	<u>(\$8,138)</u>	<u>(\$13,637)</u>	<u>\$5,499</u>

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M for both fiscal years 2005 and 2004. MSF allocated \$1.25M in administration costs to the Old Fund in fiscal years 2005 and 2004. The Old Fund has an \$893K obligation to MSF in un-recovered administrative costs incurred in fiscal years 2005 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

The change in net assets for fiscal year 2005 is a reduction of (\$8.1M) compared to a decrease of (\$13.6M) in fiscal year 2004. For an explanation of this decrease in net assets see the section on Analysis of Financial Position – Old Fund.



**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

JUNE 30,	<u>2006</u>	<u>2005</u>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	14,919,072	32,157,357
Receivables, net	15,854,354	12,929,765
Due from primary government	30,599	1,565
Due from component units	574,080	702,247
Securities lending collateral	132,438,891	101,859,456
Other assets	<u>17,313,082</u>	<u>8,428,725</u>
Total Current Assets	181,130,078	156,079,115
Noncurrent Assets		
Investments	738,857,572	656,029,020
Notes and loans receivable	34,798	35,998
Equipment	3,881,365	2,988,734
Accumulated depreciation	(2,331,912)	(1,978,512)
Intangible assets	<u>5,051,601</u>	<u>3,680,005</u>
Total Noncurrent Assets	<u>745,493,424</u>	<u>660,755,245</u>
<b>Total Assets</b>	<u><u>926,623,502</u></u>	<u><u>816,834,360</u></u>
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable	18,556,138	13,690,027
Due to primary government	1,170,730	1,071,878
Due to component units		211,852
Estimated claims payable	124,161,418	110,866,995
Compensated absences	1,096,326	1,007,739
Securities lending liability	132,438,891	101,859,456
Deferred revenue	2,106,613	4,925,828
Property held in trust	<u>22,119,223</u>	<u>13,055,107</u>
Total Current Liabilities	301,649,339	246,688,882
Noncurrent Liabilities		
Estimated claims payable	466,526,582	400,690,005
Compensated absences	<u>863,072</u>	<u>780,872</u>
Total Noncurrent Liabilities	<u>467,389,654</u>	<u>401,470,877</u>
<b>Total Liabilities</b>	<u>769,038,993</u>	<u>648,159,759</u>
<b>NET ASSETS</b>		
Invested in capital assets, net of related debt	6,601,053	4,690,227
Unrestricted	<u>150,983,456</u>	<u>163,984,374</u>
<b>Total Net Assets</b>	157,584,509	168,674,601
<b>Total Liabilities and Net Assets</b>	<u><u>926,623,502</u></u>	<u><u>816,834,360</u></u>

**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

<b>YEAR ENDED JUNE 30,</b>	<b>2006</b>	<b>2005</b>
Net premiums earned	211,892,198	189,378,858
Operating Expenses		
Benefits and claims	192,699,378	159,612,313
Personal services	18,973,653	17,168,457
Contractual services	7,448,864	12,029,017
Supplies and materials	1,110,825	867,005
Depreciation	434,183	455,407
Amortization	416,485	407,105
Rent and utilities	469,574	305,923
Communications	1,164,512	1,116,449
Travel	209,519	211,673
Repair and maintenance	1,194,908	863,245
Other operating expenses	5,493,638	2,500,685
Total Operating Expenses	229,615,539	195,537,279
Operating Loss	(17,723,341)	(6,158,421)
Nonoperating Revenue (Expenses)		
Investment income	11,756,456	35,920,969
Gains on sale of investments	442,602	1,118,749
Securities lending income	5,613,768	2,438,833
Losses on sales of investments	(698,494)	(76,863)
Securities lending expense	(5,540,476)	(2,341,264)
Penalties and interest	23,921	15,270
Loss on retirement of assets	(704)	(46,532)
Dividend expense	(5,001,042)	(5,004,416)
Other income	37,218	36,098
Total Nonoperating Revenue (Expense)	6,633,249	32,060,844
Change in Net Assets	(11,090,092)	25,902,423
Total Net Assets - Beginning	168,674,601	142,772,178
Total Net Assets - Ending	157,584,509	168,674,601

**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

<b>YEAR ENDED JUNE 30,</b>	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Receipts for premiums	214,435,780	188,037,127
Payments to suppliers for goods and services	(15,979,009)	(15,876,315)
Payments to employees	(18,390,435)	(15,944,599)
Cash payments for claims	(113,082,071)	(103,573,355)
Other operating receipts	61,139	51,368
<b>Net Cash Provided by (Used for) Operating Activities</b>	67,045,404	52,694,226
<b>CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES</b>		
Payment of Dividends to Policyholders	(5,001,042)	(5,004,416)
Payment to State of Montana		
<b>Net Cash Provided by (Used for) Noncapital Financing Activities</b>	(5,001,042)	(5,004,416)
<b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>		
Acquisition of fixed assets	(3,109,880)	(2,721,963)
Proceeds from sale of fixed assets	28,152	
<b>Net Cash Used for Capital and Related Financing Activities</b>	(3,081,728)	(2,721,963)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of investments	(194,362,049)	(155,380,802)
Proceeds from sales or maturities of investments	87,105,705	91,939,366
Proceeds from securities lending transactions	5,613,768	2,438,833
Payments of security lending costs	(5,216,110)	(2,247,180)
Interest and dividends on investments	30,657,767	29,754,247
<b>Net Cash Provided by (Used For) Investing Activities</b>	(76,200,919)	(33,495,536)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(17,238,285)	11,472,311
<b>CASH AND CASH EQUIVALENTS - JULY 1</b>	32,157,357	20,685,046
<b>CASH AND CASH EQUIVALENTS - JUNE 30</b>	14,919,072	32,157,357

**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

YEAR ENDED JUNE 30,	2006	2005
<b>RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES</b>		
Change in Net Assets	(11,090,092)	25,902,423
<b>Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities</b>		
Depreciation	434,183	455,407
Amortization	416,485	407,105
Interest expense	-	-
Security lending costs	5,540,476	2,341,264
Security lending income	(5,613,768)	(2,438,833)
Interest on investment	(11,500,564)	(36,962,854)
Payments of Dividends to Policyholders	5,001,042	5,004,416
Payment to State of Montana		
Decrease (increase) in		
Accounts receivable	(1,664,595)	580,062
Due from component units of the State of Montana	244,902	(150,062)
Notes receivable	1,200	1,200
Other assets	(8,883,654)	(6,344,145)
Increase (decrease) in		
Accounts payable	8,715,506	889,278
Due to Primary Government	(102,405)	473
Deferred revenue	(2,819,215)	(1,051,405)
Property held in trust	9,064,116	4,541,922
Estimated claims	79,131,000	59,442,000
Lease payable	-	-
Compensated absences	170,787	75,975
Total adjustments	78,135,496	26,791,803
<b>Net Cash Provided by (Used for) Operating Activities</b>	<u>67,045,404</u>	<u>52,694,226</u>

**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

JUNE 30,	<u>2006</u>	<u>2005</u>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	8,675,911	12,207,312
Receivables, net	679,809	704,270
Due from component units		211,852
Securities lending collateral	<u>14,894,170</u>	<u>17,768,750</u>
Total Current Assets	24,249,890	30,892,184
Noncurrent Assets		
Investments	<u>43,252,383</u>	<u>51,353,489</u>
<b>Total Assets</b>	<u><u>67,502,273</u></u>	<u><u>82,245,673</u></u>
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable	197,911	246,061
Due to primary government	-	851
Due to component units	574,936	702,247
Estimated claims payable	12,909,275	10,321,720
Securities lending liability	<u>14,894,170</u>	<u>17,768,750</u>
Total Current Liabilities	28,576,292	29,039,629
Noncurrent Liabilities		
Estimated claims payable	<u>60,827,384</u>	<u>68,787,280</u>
Total Noncurrent Liabilities	<u>60,827,384</u>	<u>68,787,280</u>
<b>Total Liabilities</b>	<u>89,403,676</u>	<u>97,826,909</u>
<b>NET ASSETS</b>		
Unrestricted	<u>(21,901,403)</u>	<u>(15,581,236)</u>
<b>Total Net Assets</b>	<u>(21,901,403)</u>	<u>(15,581,236)</u>
<b>Total Liabilities and Net Assets</b>	<u><u>67,502,273</u></u>	<u><u>82,245,673</u></u>

**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

<b>YEAR ENDED JUNE 30,</b>	<b>2006</b>	<b>2005</b>
Operating Expenses		
Benefits and claims	5,521,477	8,670,528
Personal services	53,530	13,279
Contractual services	814,591	987,022
Depreciation	49,665	32,205
Amortization	294,677	166,368
Other operating expenses	1,449,275	239,817
	<hr/>	<hr/>
Total Operating Expenses	8,183,215	10,109,219
	<hr/>	<hr/>
Operating Loss	(8,183,215)	(10,109,219)
	<hr/>	<hr/>
Nonoperating Revenue (Expenses)		
Investment income	1,626,768	1,964,720
Gains on investments	380,484	22,522
Securities lending income	889,927	454,567
Losses on investments	(146,654)	(25,237)
Securities lending expense	(877,365)	(445,751)
Liability tax revenue	(10,112)	(46)
	<hr/>	<hr/>
Total Nonoperating Revenue (Expenses)	1,863,048	1,970,775
	<hr/>	<hr/>
Change in Net Assets	(6,320,167)	(8,138,444)
Total Net Assets - Beginning	(15,581,236)	(7,442,792)
Total Net Assets - Ending	(21,901,403)	(15,581,236)
	<hr/> <hr/>	<hr/> <hr/>

**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

<b>YEAR ENDED JUNE 30,</b>	<b><u>2006</u></b>	<b><u>2005</u></b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Payments to suppliers for goods and services	(1,301,437)	(1,417,339)
Payments to employees	13,279	-
Cash payments for claims	(12,211,805)	(10,732,998)
Collection of payroll taxes	<u>(48,468)</u>	<u>4,985</u>
Net Cash Used for Operating Activities	(13,548,431)	(12,145,352)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of investments	(13,121,113)	(17,976,764)
Proceeds from sales or maturities of investments	20,023,976	34,403,997
Proceeds from securities lending transactions	889,926	454,567
Payments of security lending costs	(860,154)	(412,094)
Interest and dividends on investments	<u>3,084,395</u>	<u>3,769,118</u>
Net Cash Provided by Investing Activities	<u>10,017,030</u>	<u>20,238,824</u>
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	(3,531,401)	8,093,472
<b>CASH AND CASH EQUIVALENTS - JULY 1</b>	<u>12,207,312</u>	<u>4,113,840</u>
<b>CASH AND CASH EQUIVALENTS - JUNE 30</b>	<u><u>8,675,911</u></u>	<u><u>12,207,312</u></u>

**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

YEAR ENDED JUNE 30,	<u>2006</u>	<u>2005</u>
<b>RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED FOR OPERATING ACTIVITIES</b>		
Change in Net Assets	(6,320,167)	(8,138,444)
<b>Adjustments to Reconcile Change in Net Assets to Net Cash Used for Operating Activities</b>		
Security lending costs	877,364	445,751
Security lending income	(889,926)	(454,567)
Interest on investment	(1,860,598)	(1,962,005)
Decrease (increase) in		
Accounts receivable	(1,092)	12,763
Due from primary government	211,852	(149,318)
Increase (decrease) in		
Accounts payable	(65,361)	(401,202)
Due to component units	(128,162)	170,670
Estimated claims	(5,372,341)	(1,669,000)
Total adjustments	(7,228,264)	(4,006,908)
<b>Net Cash Used for Operating Activities</b>	<u>(13,548,431)</u>	<u>(12,145,352)</u>



**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
June 30, 2006 and 2005

**1. Summary of Significant Accounting Policies**

**Description of Business**

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see Note 4). No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2006 and 2005 financial statements are presented in conformance with Governmental Accounting Standards Board Statement 34, which is a comparable format to the State of Montana Comprehensive Annual Financial Report.

**Basis of Accounting**

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

**Montana State Fund**  
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Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. MSF participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. There are no legal risks that the Montana Board of Investments (BOI) is aware of regarding any STIP investments. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of \$12.4M as of June 30, 2006, represents 0.56% of the total STIP. The Old Fund STIP balance of \$8.1M as of June 30, 2006, represents 0.37% of the total STIP. MSF's STIP balance of \$29.5M as of June 30, 2005, represents 1.69% of the total STIP. The Old Fund STIP balance of \$11.6M as of June 30, 2005, represents 0.67% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one of any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

Asset-backed securities constitute 64.92% of the BOI's total STIP portfolio as of June 30, 2006. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constitute 71.72% of the Board of Investment's total STIP portfolio as of June 30, 2005.

Variable rate (floating rate) securities make up 10.28% of the BOI's total STIP portfolio as of June 30, 2006. Variable rate securities make up 24.16% of the BOI's total STIP portfolio as of June 30, 2005. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

Investments

In addition to STIP investments, MSF invests in long-term securities with the BOI. Under the provisions of the state constitution, MSF's invested assets are managed by the BOI. Securities are

**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
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stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

Effective June 30, 2005, the Board implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 – Deposit and Investment Risk Disclosures. The investment risk disclosures are described in the following paragraphs.

Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of the U.S. government securities, the State Fund fixed income instruments have credit risk as measured by major credit rating services. This risk is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires MSF and Old Fund fixed income investments, at the time of purchase, to be rated an investment grade as defined by Moody's and/or Standard & Poor's (S&P) rating services. The U.S. government securities are guaranteed directly or indirectly by the U.S. government. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. The credit ratings presented in the following table are provided by S& P's rating services. If an S&P rating is not available, a Moody's rating has been used.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. As of June 30, 2006 and 2005, all the fixed income and other equity securities were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank, State Street Bank. The Equity Index investment and State Street Bank repurchase agreement were purchased in the State of Montana Board of Investment's name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment

**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
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in a single issuer. The MSF Investment Policy requires credit risk to be limited to 3 percent in any one name except AAA rated issues will be limited to 6% while the Old Fund investment policy statement does not address concentration of credit risk. The MSF Investment Policy provides for “no limitation on U.S. government/agency securities”. MSF also has specified certain client preferences. Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit risk requirement.

For fiscal year 2006, MSF only had concentration of credit risk exposure of 12.72% to the Federal National Mortgage Association. For fiscal year 2005, MSF had concentration of credit risk exposure to the Federal National Mortgage Association of 11.75% and Federal Home Loan Mortgage Corp of 5.43%.

For fiscal year 2006, Old Fund had concentration of credit risk exposure to the Federal National Mortgage Association of 29.10%, Commercial Mortgage Trust of 7.76%, JPMorgan Chase of 5.84% and Federal Home Loan Mortgage Corp of 5.63%. For fiscal year 2005, Old Fund had concentration of credit risk exposure to the Federal National Mortgage Association of 24.78% and Federal Home Loan Mortgage Corp of 7.89%.

### Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. MSF and Old Fund investment policies do not formally address interest rate risk. In accordance with GASB Statement No. 40, the Board has selected the effective duration method to disclose interest rate risk. This method, as provided by the BOI, is “An option-adjusted measure of a bond’s (or portfolio’s) sensitivity to changes in interest rates. Duration is calculated as the average percentage change in a bond’s value (price plus accrued interest) under shifts of the Treasury curve plus/minus 100 basis points. The effective duration method incorporates the effect of the embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-throughs, CMOs and ARMs).”

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, and other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

As of June 30, 2006, the MSF portfolio held two variable rate corporate bonds with an amortized cost of \$14 million. As of June 30, 2005, the MSF portfolio held one variable rate corporate bond

**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
June 30, 2006 and 2005

with an amortized cost of \$4 million. The MSF variable-rate securities float with LIBOR (London Interbank Offered Rate), or a residual component.

MSF and Old Fund investments are categorized below to disclose credit and interest rate risk as of June 30, 2006 and June 30, 2005. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. Both the credit quality ratings and duration have been calculated excluding cash equivalents.

Specific Legal and Credit Risk

As of June 30, 2005, Delta Airlines Corp. presented a higher credit risk to the BOI. The All Other Funds (AOF) portfolio held a \$10 million par 6.417% Delta Airlines Corp. bond maturing July 2, 2012. The book value of this security was \$9,968,673 as of June 30, 2005. This issue was insured by MBIA Insurance Corp. to support the payment of any interest due and outstanding principal balance. Delta Airlines Corp. filed for Chapter 11 bankruptcy protection on September 14, 2005. Since this issue was insured, the Board did not stop the interest income accrual or reduce the book value. In April 2006, the outstanding principal and interest of \$10,187,163 for this security was paid by the MBIA Insurance Corp. The Board recorded a gain of \$27,677 on this transaction.

As of June 30, 2005, Northwest Airlines Inc. presented a higher credit risk to the BOI. The AOF portfolio held a \$4,137,515 par 6.81% Northwest Airlines Inc. bond maturing February 1, 2020. The book value of this security was \$4,084,548 as of June 30, 2005. Due to the company's filing for Chapter 11 bankruptcy protection on September 14, 2005, the Board stopped the interest income accruals after the August 2005 pay date. This issue was sold on September 20, 2005 generating a loss of \$358,311. The sale included accrued interest from August 1, 2005 to September 20, 2005.

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**MSF Credit Quality Rating and Effective Duration as of June 30, 2006**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 343,140,818	A	3.91
U.S. Govt Direct-Backed	33,644,312	AAA	5.54
U.S. Govt Indirect-Backed	278,695,080	AAA	3.33
STIP (Unrated)	<u>12,396,116</u>	<u>NR</u>	NA
Total Fixed Income Investments	667,876,326		
<u>Direct Investments</u>			
Equity Index Fund	\$ <u>83,377,362</u>		
Total Investments	\$ <u>751,253,688</u>	<u>AA-</u>	<u>3.74</u>
Securities Lending Collateral Investment Pool	\$ <u>132,438,891</u>	NR	NA

**MSF Credit Quality Rating and Effective Duration as of June 30, 2005**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 299,185,736	A	4.84
U.S. Govt Direct-Backed	17,805,771	AAA	7.45
U.S. Govt Indirect-Backed	259,195,259	AAA	3.67
State Street Repo* (Rated)	3,105,156	AA-	NA
STIP (Unrated)	<u>29,462,578</u>	<u>NR</u>	NA
Total Fixed Income Investments	608,754,500		
<u>Direct Investments</u>			
Equity Index Fund	\$ <u>76,737,097</u>		
Total Investments	\$ <u>685,491,597</u>	<u>AA-</u>	<u>4.39</u>
Securities Lending Collateral Investment Pool	\$ <u>101,859,456</u>	NR	NA

\* At June 30, 2005, the State Street Bank repurchase agreement was collateralized at \$3,182,153 by a Federal Home Loan Mortgage Corporation note maturing February 15, 2006.

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**Credit Quality Rating and Effective Duration as of June 30, 2006**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 13,714,502	AA	1.63
U.S. Govt Direct-Backed	10,016,309	AAA	2.65
U.S. Govt Indirect-Backed	19,521,572	AAA	1.63
STIP (Unrated)	<u>8,101,168</u>	<u>NR</u>	<u>NA</u>
Total Investments	\$ <u>51,353,551</u>	<u>AA+</u>	<u>1.86</u>
Securities Lending Collateral Investment Pool	\$ <u>14,894,170</u>	NR	NA

**Credit Quality Rating and Effective Duration as of June 30, 2005**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 8,174,889	BBB+	0.96
U.S. Govt Direct-Backed	15,927,393	AAA	2.04
U.S. Govt Indirect-Backed	26,216,154	AAA	1.56
State Street Repo (Rated)*	1,035,052	AA-	NA
STIP (Unrated)	<u>11,599,288</u>	<u>NR</u>	<u>NA</u>
Total Investments	\$ <u>62,952,776</u>	<u>AA+</u>	<u>1.62</u>
Securities Lending Collateral Investment Pool	\$ <u>17,768,750</u>	NR	NA

\* At June 30, 2005, the State Street Bank repurchase agreement was collateralized at \$1,060,718 by a Federal Home Loan Mortgage Corporation note maturing February 15, 2006.

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MSF investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered, or securities held by the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank (SSB), to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to but not less than 100% of the fair value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2006 and June 30, 2005, the BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total cash collateral held for fiscal years ended June 30, 2006 and June 30, 2005 for both MSF and the Old Fund:

	<u>MSF</u>		<u>Old Fund</u>	
	Fiscal Year	Fiscal Year	Fiscal Year	Fiscal Year
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Securities on Loan-Book Value	\$130,560,457	\$115,170,586	\$14,605,995	\$17,158,630
Securities on Loan-Market Value	\$130,023,855	\$99,953,577	\$14,483,751	\$17,422,180
Total Collateral Held	\$132,438,891	\$101,859,456	\$14,894,170	\$17,768,750

As of June 30, 2006, MSF and the Old Fund investments include \$130.6M and \$14.6M respectively, in long-term securities on loan that earned interest income during the fiscal year of



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\$5.6M and \$890K (thousand) respectively. Expenses related to long-term securities on loan for MSF and Old Fund for June 30, 2006 were \$5.5M and \$877K respectively.

As of June 30, 2005, MSF and the Old Fund investments include \$115.2M and \$17.2M respectively, in long-term securities on loan that earned interest income during the fiscal year of \$2.4M and \$455K respectively. Expenses related to long-term securities on loan for MSF and Old Fund for June 30, 2005 were \$2.3M and \$446K respectively.

In November 2000, the Montana Constitution was amended to allow MSF to invest in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. However, in May 2003, the BOI approved a policy statement to keep equities in the 8% to 12% range. As of June 30, 2006, equity securities in MSF include \$68.4M at book value, enhanced by \$15.0M in market value appreciation. As of June 30, 2005, equity securities in MSF include \$68.4M at book value, enhanced by \$8.3M in market value appreciation.

Additional investment information can be found in Note 2.

Receivables

At June 30, 2006, MSF's receivable balance is \$9.0M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of \$2.7M leaving a net receivable balance of \$6.3M. Other receivables include \$9.5M in investment income due and \$158K in notes and loans receivable, of which \$35K is long term.

At June 30, 2005, MSF's premium receivable balance is \$5.3M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of \$726K leaving a net receivable of \$4.6M. Other receivables include \$8.2M in investment income due and \$146K in notes and loans receivable, of which \$36K is long term.

Accounts receivable in the Old Fund include medical overpayments and remaining receivables from the Old Fund Liability Tax collections. Old Fund accounts receivable for year ended June 30, 2006 and June 30, 2005 were \$1.34M and \$90K, respectively. Estimated uncollectible receivables are reported as an allowance for doubtful accounts and are recorded at \$1.29M and \$38K for the years ended June 30, 2006 and June 30, 2005 respectively. Interest receivable of \$627K at June 30, 2006 and \$653K at June 30, 2005 represent investment income due.

Equipment, Accumulated Depreciation and Intangible Assets

Equipment is capitalized if the actual or estimated historical cost exceeds \$5K. Depreciation

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expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF financials. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets.

Other Assets

Other assets include advances, prepaid expenses and deferred acquisition costs. Deferred acquisition costs are amounts incurred during the policy writing process that are recognized ratably over the related policy term.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study that provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated claims payable for both MSF and Old Fund. For additional disclosure related to the estimated claims payable, refer to Note 4.

Accounts Payable

Accounts payable is a short term liability account reflecting amounts owed for goods and services received by MSF.

Deferred Revenue

Deferred revenue reflects amounts received or billed in advance, but not yet earned for policies effective July 1, 2006 or July 1, 2005.

Property Held in Trust

Property Held in Trust consists of security deposits owed to certain policyholders and the reinsurance funds withheld account, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

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Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 6.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but

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has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

## 2. Investments

The amortized cost and market value of MSF's fixed maturity and equity securities as of June 30, 2006, and June 30, 2005, are as follows:

<u>June 30, 2006</u>	<u>Gross Unrealized</u>				<u>Market Value</u>
	<u>Amortized Cost</u>	<u>Gain</u>	<u>Loss</u>		
Government Direct-Indirect	\$ 298,646,776	\$ 1,068,039	\$ 7,285,782	\$	292,429,033
Government Mortgage-Backed	20,208,115	21,769	319,525		19,910,359
Corporate Securities Asset-Backed	36,640,073	-	794,411		35,845,663
Other Corporate Securities	300,626,964	2,211,091	9,384,126		293,453,929
Other Securities	13,985,513	221,971	366,258		13,841,226
Equity Securities	68,406,676	14,970,686	-		83,377,362
STIP	12,396,116	-	-		12,396,116
Total	\$ 750,910,234	\$ 18,493,556	\$ 18,150,102	\$	751,253,688

<u>June 30, 2005</u>	<u>Gross Unrealized</u>				<u>Market Value</u>
	<u>Amortized Cost</u>	<u>Gain</u>	<u>Loss</u>		
Government Direct-Indirect	\$ 244,379,693	\$ 6,332,933	\$ 628,853	\$	250,083,773
Government Mortgage-Backed	26,134,547	782,710			26,917,257
Corporate Securities Asset-Backed	24,310,182	-	312,525		23,997,657
Other Corporate Securities	256,757,098	8,848,355	2,892,808		262,712,645
Other Securities	15,056,974	525,794	2,177		15,580,591
Equity Securities	68,406,676	8,330,421			76,737,097
STIP	29,462,576				29,462,576
Total	\$ 664,507,746	\$ 24,820,213	\$ 3,836,363	\$	685,491,596

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2006 and June 30, 2005, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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**June 30, 2006**

	<b><u>Amortized Cost</u></b>	<b><u>Market Value</u></b>
Due one year or less	\$ 72,383,275	\$ 72,088,693
Due after one year through five years	346,456,863	338,447,216
Due after five years through ten years	216,052,865	209,755,675
Due after ten years	47,610,555	47,584,741
Equity Securities	<u>68,406,676</u>	<u>83,377,362</u>
Total	<u>\$ 750,910,234</u>	<u>\$ 751,253,688</u>

**June 30, 2005**

	<b><u>Amortized Cost</u></b>	<b><u>Market Value</u></b>
Due one year or less	\$ 18,584,037	\$ 18,737,683
Due after one year through five years	337,703,075	342,545,705
Due after five years through ten years	172,312,177	177,837,490
Due after ten years	67,501,781	69,633,622
Equity Securities	<u>68,406,676</u>	<u>76,737,097</u>
Total	<u>\$ 664,507,746</u>	<u>\$ 685,491,597</u>

During the fiscal year ending June 30, 2006, MSF realized gross gains from sales of securities of \$443K and gross realized losses of \$698K. During the fiscal year ending June 30, 2005, MSF realized gross gains from sales of securities of \$1.1M and gross realized losses of \$77K.

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2006, investment income for MSF reflects a decrease of \$20.6M due to the unrealized loss on long-term investments. Investment income for fiscal year 2005 reflects an increase of \$6.8M due to the unrealized gain on long-term investments.

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2006 and June 30, 2005 are as follows:

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<u>June 30, 2006</u>	<u>Gross Unrealized</u>			
	<u>Amortized Cost</u>	<u>Gain</u>	<u>Loss</u>	<u>Market Value</u>
Government Direct-Indirect	\$ 28,320,200	\$ 27,761	\$ 498,423	\$ 27,849,538
Government Mortgage-Backed	1,694,255	5,244	11,158	\$ 1,688,342
Corporate Securities Asset-Backed	6,304,106	0	140,517	\$ 6,163,589
Other Corporate Securities	7,596,719	3,807	49,611	\$ 7,550,914
Other Securities	0	0	0	
STIP	8,101,168	0	0	\$ 8,101,168
Total	<u>\$ 52,016,448</u>	<u>\$ 36,812</u>	<u>\$ 699,709</u>	<u>\$ 51,353,551</u>

<u>June 30, 2005</u>	<u>Gross Unrealized</u>			
	<u>Amortized Cost</u>	<u>Gain</u>	<u>Loss</u>	<u>Market Value</u>
Government Direct-Indirect	\$ 35,645,353	\$ 493,221	\$ 180,157	\$ 35,958,417
Government Mortgage-Backed	2,415,662	85,099	0	2,500,761
Corporate Securities Asset-Backed	2,680,027	0	79,256	2,600,771
Other Corporate Securities	10,264,099	172,357	142,916	10,293,540
Other Securities	0	0	0	
STIP	11,599,288	0	0	11,599,288
Total	<u>\$ 62,604,429</u>	<u>\$ 750,677</u>	<u>\$ 402,329</u>	<u>\$ 62,952,777</u>

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2006 and June 30, 2005 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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**June 30, 2006**

	<u>Amortized Cost</u>	<u>Market Value</u>
Due one year or less	\$ 8,221,472	\$ 8,203,492
Due after one year through five years	34,068,761	33,628,676
Due after five years through ten years	3,422,109	3,357,794
Due after ten years	<u>6,304,106</u>	<u>6,163,589</u>
Total	<u><u>52,016,448</u></u>	<u><u>51,353,551</u></u>

**June 30, 2005**

	<u>Amortized Cost</u>	<u>Market Value</u>
Due one year or less	\$ 10,690,003	\$ 10,767,056
Due after one year through five years	38,652,218	38,643,573
Due after five years through ten years	10,582,181	10,941,377
Due after ten years	<u>2,680,027</u>	<u>2,600,771</u>
Total	<u><u>\$ 62,604,429</u></u>	<u><u>\$ 62,952,777</u></u>

During the fiscal year ended June 30, 2006, the Old Fund realized \$380K in gross gains from sales of securities and \$147K in gross losses from sales of securities. During the fiscal year ended June 30, 2005, the Old Fund realized \$23K in gross gains from sales of securities and \$25K in gross losses from sales of securities.

During fiscal year 2006, the effect of GASB 31 on Old Fund investment income was a decrease of \$1.0M due to unrealized losses on its long-term portfolio. The effect of GASB 31 on Old Fund investment income for fiscal year 2005 was a decrease of \$1.2M due to unrealized losses on its long-term portfolio.

### **3. Reinsurance**

For the fiscal years ended June 30, 2006 and June 30, 2005, MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that

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aggregate losses will exceed expected levels expressed as a percentage of premium. The excess of loss contracts provide coverage of \$95.0M for both fiscal years 2006 and 2005. During fiscal years 2006 and 2005, MSF retained the first \$5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to \$5.0M per any one individual loss for both fiscal years 2006 and 2005.

The term of the current aggregate stop loss contract is July 1, 2005 through June 30, 2008. The contract provides coverage based on MSF's premium levels at a maximum of \$33.8M per year and a minimum of \$28.5M but in aggregate not to exceed 80.0% of the sum of the annual limits for all contract years. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of \$13.6M and \$6.8M in fiscal years 2006 and 2005, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2006 is \$17.0M. The funds withheld account at June 30, 2005 was \$7.8M. Interest must be accrued quarterly at an annual rate of 5.0% for the fiscal year 2006 funds withheld account and 6.5% for the fiscal year 2005 funds withheld account, resulting in accrued interest of \$1.0M for fiscal year 2006 and \$547K for fiscal year 2005.

During fiscal years 2006 and 2005, estimated claim reserves were reduced \$10.0M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excessive loss reinsurance contract. In fiscal year 2006 and 2005 estimated claim reserves were reduced by an additional \$2.9M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2006 and 2005 is \$2.2M and \$2.7M, respectively. The assumed liability for OSC claims is \$2.9M for fiscal year 2006 and \$2.4M for fiscal year 2005.

#### **4. Risk Management**

MSF provides liability coverage to employers for injured employees that are insured under the



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Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. At June 30, 2006, approximately 28,410 active policies were insured by MSF. At June 30, 2005, approximately 27,527 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the insurer of last resort for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

MSF serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the Old Fund. Should the reserves in the Old Fund become inadequate the State of Montana and general fund will be obligated to cover benefit payments. Neither MSF nor the Old Fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2006 and June 30, 2005. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2006 and 2005. The MSF estimated unpaid claims and claims adjustment expenses payable is presented at face value, net of estimated reinsurance recoverable, at \$590.7M and \$511.6M, as of June 30, 2006 and June 30, 2005, respectively. The estimated claims payable increased \$79.1M from 2005 to 2006, which included reserve strengthening of approximately \$30.9M on prior year claims. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

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State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2006 and June 30, 2005 are \$775K and \$1.3M respectively. For the years ended June 30, 2005 and June 30, 2004, acquisition costs that were amortized are \$1.3M and \$1.1M, respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments was provided by Old Fund Liability Taxes (OFLT), which are no longer in effect. The only OFLT activity that remains is miscellaneous collections and adjustments. Old Fund investment earnings must fund future claims payments.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2006 and June 30, 2005, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2006 and 2005. As of June 30, 2006, the undiscounted estimated claims payable is \$97.8M and is presented at net present value of \$73.7M discounted at a 5.0% rate. As of June 30, 2005, the undiscounted estimated claims payable is \$104.9M and is presented at net present value of \$79.1M discounted at a 5.0% rate.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years, net of estimated reinsurance recoverable. The information presented has not been discounted.

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	<b>MSF</b>	
	<b>2006</b>	<b>2005</b>
Unpaid claims and claim adjustment expenses at beginning of year	\$511,557,000	\$452,115,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	170,398,933	149,541,838
Increase(Decrease) in provision for events in prior years	35,438,825	10,070,475
Total incurred claims and claim adjustment expenses	205,837,758	159,612,313
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(36,131,780)	(25,721,288)
Claims and claim adjustment expenses attributable to insured events of PY	(90,574,978)	(74,449,025)
Total payment	(126,706,758)	(100,170,313)
Total unpaid claims and claim adjustment expenses at end of the year	590,688,000	511,557,000

	<b>(OLD FUND - undiscounted)</b>	
	<b>2006</b>	<b>2005</b>
Unpaid claims and claim adjustment expenses at beginning of year	104,851,596	108,499,935
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	-	-
Increase(Decrease) in provision for events in prior years	3,811,030	6,691,189
Total incurred claims and claim adjustment expenses	3,811,030	6,691,189
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(10,893,818)	(10,339,528)
Claims and claim adjustment expenses attributable to insured events of PY	(10,893,818)	(10,339,528)
Total payment	(10,893,818)	(10,339,528)
Total unpaid claims and claim adjustment expenses at end of the year	97,768,808	104,851,596

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Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1997 through 2006. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

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(In millions)

	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>1. Premiums and Investment Revenue</b>										
Earned	105,417	90,808	82,760	91,565	116,548	129,886	166,146	174,388	222,230	170,973
Ceded	348	303	260	855	2,952	(465)	5,654	6,563	6,788	13,618
Net Earned	105,069	90,506	82,500	90,709	113,596	130,351	160,493	167,825	215,442	157,355
<b>2. Unallocated expenses including overhead</b>	12,536	14,322	18,923	22,019	26,670	29,393	32,497	39,057	41,543	45,558
<b>3. Estimated losses and expenses, end of accident year</b>										
Incurred	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290	155,057
Ceded	-	-	-	-	-	-	-	-	-	-
Net Incurred	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290	155,057
<b>4. Net paid (cumulative) as of:</b>										
End of policy year	12,589	12,943	13,723	13,177	14,140	16,693	22,982	26,123	25,721	30,977
One year later	28,451	28,222	29,976	29,218	32,888	38,185	48,861	50,888	57,239	-
Two years later	35,706	35,753	39,298	37,555	45,218	52,359	63,773	66,140	-	-
Three years later	39,860	41,004	45,748	43,649	55,248	60,029	72,957	-	-	-
Four years later	43,105	44,478	49,984	48,322	61,846	64,922	-	-	-	-
Five years later	46,478	47,584	54,212	52,027	66,031	-	-	-	-	-
Six years later	48,505	50,188	56,974	54,473	-	-	-	-	-	-
Seven years later	50,402	52,240	59,935	-	-	-	-	-	-	-
Eight years later	52,285	54,004	-	-	-	-	-	-	-	-
Nine years later	54,204	-	-	-	-	-	-	-	-	-
<b>5. Re-estimated ceded losses and expenses</b>	6,645	609	1,940	-	-	-	2,901	-	-	-
<b>6. Re-Estimated net incurred losses and expense:</b>										
End of policy year	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290	155,056
One year later	67,235	64,308	64,348	66,421	71,094	86,799	110,532	112,609	136,235	-
Two years later	59,054	60,467	66,660	66,662	81,053	91,241	112,443	124,413	-	-
Three years later	60,811	61,989	69,345	70,302	88,157	94,615	117,245	-	-	-
Four years later	64,439	64,944	72,435	72,492	92,329	99,755	-	-	-	-
Five years later	59,079	67,312	73,710	73,423	95,727	-	-	-	-	-
Six years later	60,528	67,772	75,537	76,048	-	-	-	-	-	-
Seven years later	60,630	68,601	78,046	-	-	-	-	-	-	-
Eight years later	60,774	69,764	-	-	-	-	-	-	-	-
Nine years later	62,446	-	-	-	-	-	-	-	-	-
<b>7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year</b>	(13,621)	4,781	13,401	10,091	27,460	18,195	7,092	3,708	1,945	(0)

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**5. Administrative Cost Allocation**

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M. MSF allocated \$1.25M in administration costs to the Old Fund in each of fiscal years 2006 and 2005. The Old Fund has a \$576K obligation to MSF in unrecovered administrative costs incurred in fiscal years 2005 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

**6. MSF Distributions**

Dividends Paid to Policyholders

During the fiscal years ended June 30, 2006 and June 30, 2005, the MSF Board of Directors authorized and paid dividends to policyholders for \$5.0M for policy year 2004 and \$5.0M for policy year 2003, respectively.

Payments from Old Fund to MSF and State of Montana

House Bill Number 363 (HB 363), enacted by the 2003 Montana Legislature, changed existing law regulating the Old Fund transfer of surplus. HB 363 removed the 10% contingency reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the State of Montana General Fund.

There was no transfer amount to the General Fund for fiscal years 2006 and 2005. Refer to Note 7 for additional information regarding HB 363.

**7. Old Fund Net Asset Position**

As of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.0% to determine compliance with state law requirements for maintaining fund adequacy.

Section 39-71-2352 (5), MCA, provided for the payment of excess funds from the Old Fund to the State of Montana General Fund based on adequate funding levels in the Old Fund. This law defined the term "adequately funded" to mean the present value of:

- a) the total cost of future benefits remaining to be paid; and,

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- b) the cost of administering the claims; and,
- c) adjusted for any unrealized gains and losses.

As stated in Note 6, HB 363, enacted by the 2003 Montana Legislature, changed the law regulating the Old Fund transfer of surplus. HB 363 requires the transfer of any amounts above the amount of “adequately funded” to the State of Montana General Fund. In addition, future excess funds will continue to be transferred to the General Fund.

There were no excess funds to transfer to the General Fund as of June 30, 2006 and June 30, 2005 as a result of HB363. In order to value liabilities consistently with investments, the estimated claims liability discount rate is 5.0% in fiscal years 2006 and 2005. The Old Fund net asset level, using a present value discount factor of 5.0%, is \$(21.9M) as of June 30, 2006. Using a present value discount factor of 5.0% as of June 30, 2005, the net asset level is \$(15.6M). The negative balance for June 30, 2006 is the direct result of the transfers made from the Old Fund to the General Fund mandated by HB 363. This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there are sufficient invested assets to meet its obligations until the year 2013. Current law requires the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations.

## **8. Compensated Absences**

MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF may allocate some of these costs to Old Fund as a portion of the Old Fund administrative cost allocation. The total leave liability for MSF and Old Fund is \$2.0M and \$0, respectively, for fiscal year 2006. The total leave liability for MSF and Old Fund is \$1.8M and \$0, respectively, for fiscal year 2005.

## **9. Retirement Plans**

MSF and its employees contribute to the Public Employees’ Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees’ Retirement Board

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(PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2006 and 2005. MSF's contributions amounted to \$1.0M for fiscal year 2006 and \$867K for fiscal year 2005. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2006.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from PERB at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, 406 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

## **10. Building**

The 1981 Legislature appropriated funds for the construction of a workers' compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under an agreement, which expires on July 31, 2007, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.



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**11. Contingencies**

***Stavenjord v. State Compensation Insurance Fund.*** The first *Stavenjord* decision was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the *Henry* case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court held that MCA §39-72-405 is unconstitutional as applied to Debra Stavenjord. "Where PPD benefits calculated pursuant to the WCA are greater than the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to \$27,027 under the WCA, versus \$10,000 under the ODA." The Montana Supreme Court affirmed the case on April 1, 2003. On August 27, 2004 the Workers Compensation Court held that *Stavenjord* is retroactive to June 3, 1999 (the date of the *Henry* decision). The Court held that a common fund is created for claimants reaching Maximum Medical Improvement on or after June 3, 1999. The cost of retroactively paying benefits for claims in the period of June 3, 1999 through May 21, 2001, is estimated at \$2.2 million and is recorded in the loss reserves of the financial statements. There is no impact on the Old Fund liability with this ruling. This decision has been appealed to the Montana Supreme Court. Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively to 1987, the cost is estimated at \$14 to \$19 million dollars for the Montana State Fund (New Fund- for claims on or after July 1, 1990). Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively to 1987, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at \$5 to \$7 million. Final disposition is unknown at this time. The outcome of a ruling reversing the Workers' Compensation Court by the Montana Supreme Court that would increase MSF and state of Montana liability is reasonably possible. Actual cost impact should the Montana Supreme Court reverse the Workers' Compensation Court ruling is unknown.

***Schmill v. Liberty Northwest Insurance,*** 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, "We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill's permanent impairment award for her occupational disease pursuant to § 39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that § 39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers' Compensation Court is affirmed." The Workers' Compensation Court determined that a common fund existed and the case was retroactive to July 1, 1987. This decision was affirmed on appeal to the Montana Supreme Court. The June 7, 2005 decision of the Montana Supreme Court created a common fund and applied the decision retroactively. The cost is estimated to be \$1.4 to \$1.9 million

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dollars for MSF. The decision of the Montana Supreme Court is estimated to impact the Old Fund liability in the amount of \$800,000 for claims that occurred before July 1, 1990. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund and the Old Fund. Implementation and retroactivity issues are presently before the Workers' Compensation Court. This case is recorded in loss reserves.

***Wild v. Fregein and Montana State Compensation Insurance Fund***, 2003 MT 115, decided April 29, 2003, primarily held that § 39-71-401(3), MCA, does not, as a matter of law, conclusively preclude any factual inquiry into whether an employer/employee relationship exists once the worker has been issued the exemption contemplated by § 39-71-401(3), MCA., and .... "that § 39-71-401(3), MCA, read in conjunction with § 39-71-120, MCA, does require the employer to make an initial good faith inquiry of the worker to determine that he or she does, in fact, meet the control and independently established business tests before the employer employs the worker as an IC [Independent Contractor] and if the employer determines the worker is an IC, to thereafter treat the worker as an IC and not as an employee as Fregein treated Wild in this case." The case was heard in conjunction with a similar case filed against Liberty Northwest, Mathews v. Liberty Northwest. Retroactive application of the Wild decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. The Workers' Compensation Court did however issue a decision in Mathews v. Liberty Northwest, holding that the case was not retroactive and a common fund not created. The Worker's Compensation Court on June 1, 2005 ruled in remand on the issue of retroactivity and held that the decision should be retroactive. The Mathews case was appealed to the Montana Supreme Court, but was dismissed on October 7, 2005. As data on identification of potential claims is difficult to identify, no analysis of cost estimates on retroactive application of the decision is available at this time and final disposition is unknown. The probable outcome of litigation creating a cost impact on Montana State Fund is remote.

***Satterlee v. Lumberman's Mutual Casualty Company et al., WCC No. 2003-0840***, was filed before the Workers' Compensation Court on July 18, 2003. The *Satterlee vs. Lumberman's Mutual Casualty Company* case challenges the constitutionality of state statute, (39-71-710, MCA) passed by the Montana Legislature in 1981. That statute authorizes termination of permanent total disability benefits and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. Should the statute be found to be unconstitutional as applied to permanent total benefits, *Satterlee, et al.* request payment of lifetime permanent total disability benefits. In addition, the petition requests certification of this case as a class action or the establishment of a common fund for similarly situated claimants. Petitioners filed a motion and brief for summary judgment on the constitutional issue. The Worker's Compensation Court provided an opportunity for any workers' compensation insurer to intervene until June 6, 2005. The Workers' Compensation Court rendered its decision on December 12, 2005, holding that § 39-71-710, MCA is constitutional as applied to PTD benefits. A motion requesting reconsideration was filed by

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petitioner and granted in part. These issues on reconsideration have been fully briefed. It is likely that the case will be appealed to the Supreme Court. Should 39-71-710, MCA ultimately be held to be unconstitutional as applied to permanent total disability benefits by the Montana Supreme Court, and also found to apply retroactively, the cost impact has been estimated for non-settled claims arising on or after July 1, 1990 through December 22, 2004 at \$135 million to \$186 million. The estimated cost of retroactively applying the decision to the Old Fund, for non-settled permanent total disability claims that occurred before July 1, 1990 is \$93 to \$116 million. The potential for liability for MSF and the state of Montana is reasonably possible. Actual cost impact is unknown.

***Reesor v. Montana State Fund, 2004 MT 370.*** *Reesor* was receiving social security retirement benefits at the time he suffered an industrial accident. He received an impairment award but was denied other permanent partial disability (PPD) benefits pursuant to section 39-71-710, MCA, which provides that persons who are receiving social security benefits or are eligible for full social security retirement benefits are ineligible for PPD benefits other than an impairment award. *Reesor* challenged the constitutionality of section 39-71-710, MCA, on equal protection grounds and sought full PPD benefits. On July 26, 2003, the Workers' Compensation Court found 39-71-710, MCA, to be constitutional. *Reesor* appealed to the Montana Supreme Court, where on December 22, 2004, the Court held that limiting *Reesor's* permanent partial benefit pursuant to 39-71-710, MCA, violated the Equal Protection Clause of the Montana Constitution. Pending before the Workers' Compensation Court are the retroactive application of the decision and common fund status. MSF has estimated the cost of benefits associated with a retroactive application of *Reesor*. MSF's estimate did not include claims with entitlement dates occurring on or after July 1, 1991 through June 30, 1995 because the *Russette* decision appears to make *Reesor* inapplicable during that timeframe. Excluding the *Russette* timeframe, for claims arising on or after July 1, 1990 through December 22, 2004, the increase in benefit costs for MSF is estimated at \$2.0 million. For claims arising on or after July 1, 1987 through June 30, 1990, the retroactive application of *Reesor* will result in an estimated benefit cost increase of \$1.0 million for the Old Fund. The potential for the litigation to create a liability for MSF and the state of Montana is reasonably possible. Actual cost impact should the decision be applied retroactively is unknown.



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November 14, 2006

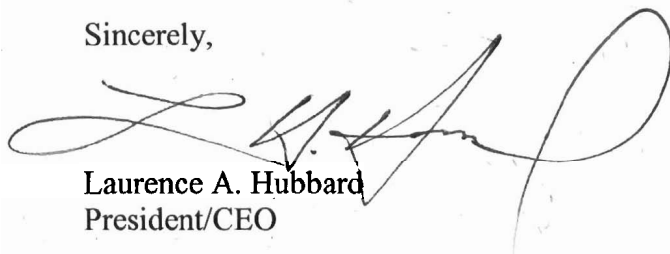
Mr. Scott A. Seacat  
Legislative Audit Division  
Room 160, State Capitol  
Helena, MT 59620-1705

Dear Mr. Seacat:

Montana State Fund (MSF) appreciates the efficient and professional approach of the audit staff involved in this review of our governmental financial statements. Once again, we are pleased with your issuance of an unqualified opinion without any audit recommendations on the financial statements we have presented.

The management and staff of MSF are very proud of our accomplishments in serving Montana businesses. We continually strive to improve our operations to ensure Montana businesses and the community will continue to benefit from a strong Montana State Fund many years into the future.

Sincerely,



Laurence A. Hubbard  
President/CEO

LAH/sh